
Jaipur Tribunal applies percentage completion method for recognising revenue on advances received by developers

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In brief

In a recent decision,¹ the Jaipur Income-tax Appellate Tribunal (“Tribunal”) held that in case of a taxpayer engaged in the development of township projects, advance received from the buyers on unregistered sale agreements should be recognised as income in the year in which the advance is received. Further, for computing the amount of income to be recognised as income the Tribunal held that the taxpayer should apply the percentage completion method (‘PCM’) only on the amount of advance realised by the taxpayer during the year, and not on the amount of total sale consideration.

In cases where the sale agreements were registered, the Tribunal rejected the tax officer’s (‘TO’) stand that the entire sale consideration should be recognised as income in the year in which the sale agreement is registered, and held that the revenue should be recognised by applying PCM on the amount of total sale consideration.

In detail

Facts

- The taxpayer was engaged in the development of a township project.
- The taxpayer followed the mercantile system of accounting and recognised revenue using the PCM in line with ICAI’s “Guidance Note on Accounting for Real Estate Transactions” (revised 2012).
- The accounting policy of the taxpayer had been duly reflected in its audited financial statements.
- The taxpayer, in the year under consideration, had

recognised revenue on the PCM basis with respect to the agreements entered into with the buyers, which had been registered. However, the advances received with respect to agreements executed but not registered had not been offered to tax.

- The TO held that revenue with respect to advances received, which pertain to unregistered sale agreements, would need to be recognised by applying PCM on the amounts realised.
- The TO further held that with respect to the agreements that have been registered, the entire sale

consideration (without application of PCM) was to be recognised as revenue.

Issues before the Tribunal

- Treatment of advances received from the buyers, where the sale deeds have not been registered; and Recognition of revenues pertaining to sales of plots made by the taxpayer where the sale deeds have been registered (whether the whole sale consideration is to be offered to tax or only a percentage of the sale consideration, taking into account the application of PCM).

¹ ITA No. 105/JP/2017

Taxpayer's contentions

- The Revenue had resorted to non-application of PCM where the sale deed had been registered but applied the principle where advances had been received with respect to unregistered sale deeds.
- In case of advance received, revenue could be recognised only when significant risks and rewards of ownership were transferred to the buyer.
- The agreements categorically provided that if the buyer defaulted in depositing the instalment amounts (maximum two times), the taxpayer would have the right to cancel the agreement. Additionally, the agreements also provided that the onward transfer of the plot by the buyer would be at the sole discretion of the taxpayer requiring his prior written approval. The taxpayer contended that these clauses in the agreements clearly established the position that the buyer had no legal right to transfer his interest in the property until the entire sale consideration was paid by him.
- In addition, the taxpayer contended that as per the consistent accounting policy that it followed, revenue in respect of advance received was said to accrue only when the sale deed was registered and not on the basis of the plot buyer's agreement.
- With respect to the TO's contention of bringing the entire consideration in respect of registered sale deeds to tax (instead of a certain percentage of sale consideration determined by applying the PCM), the taxpayer contended that the entire sale consideration cannot be considered as revenue, as the taxpayer was

yet to incur expenses against such receipts.

- Further, the TO, in bringing to tax the entire sales consideration with respect to registered sale deeds had ignored paragraph 4 of the "Guidance Note on Accounting for Real Estate Transactions" (revised 2012), which provided that in case the seller was obliged to perform any substantial acts after the transfer of all significant risks and rewards of ownership, revenue was to be recognised by applying the PCM in the manner explained in AS-7 on "Construction Contracts."

Revenue's contention

- The Revenue contended that though the taxpayer was claiming to follow the PCM, revenues with respect to advances received had not been recognised at all.
- In case of a real estate developer, after signing an agreement to sell, the seller acquires an infallible right over the payments towards the sale consideration. Further, the buyer also acquires ownership of right in the property much before the transfer of legal title in his favour.
- In view of the above, non-recognition of revenue until registration of sale deeds with respect to which advances were received was not acceptable.
- Further, with respect to the recognition of sale consideration for registered sale deeds, the revenue contended that significant risks and rewards pertaining to the plot had been transferred by the taxpayer, and the taxpayer also had a right to receive the future amounts whose recovery was

secured in view of the post-dated cheques procured from the buyer at the time of the sale. In view of these facts, the TO held that the whole sale consideration pertaining to registered sale deeds was to be recognised as revenue.

Tribunal's decision

- The Tribunal held that on a cumulative reading of the clauses in a sample sale deed, it was clear that the taxpayer transferred the price risk and external regulatory risk relating to the plot to the buyer.
- Further, the requirement of prior written approval of the taxpayer for transfer of the plot to a third party cannot in any way mean to restrict the right of the buyer to deal with the plot but was only a regulatory mechanism put in place by the taxpayer.
- Where the taxpayer was not offering income received by way of advance to tax, the taxpayer was in effect following the project completion method, wherein the income is offered to tax only on completion or substantial completion of the project.
- As the taxpayer was consistently recognising revenues based on PCM, it could not be allowed to breach the very same method by not offering the advances received during the year to tax.
- The Tribunal ruled that AS-9 on revenue recognition specifically mentions that revenue recognition is to be postponed to the extent of uncertainty involved in terms of realisation, and hence, the amount that was actually received during the year by way of advances from buyers ought to be recognised as

revenue to the extent of percentage of work completed.

- The Tribunal held that where advances were received in respect of unregistered sale deeds, the TO was correct in applying the PCM to the advances so received.
- The Tribunal further held that where the sale deeds had been duly executed and registered, there was no dispute that the taxpayer had transferred all significant risks and rewards to the buyer. However, it was pertinent to note that the agreed price for the plot included the performance of specified development activities (which in this case were development of roads, electricity, water, etc.). The Tribunal restated that the buyer was not paying merely for a piece of land cut into specified size at a given

location, but also for such specified development activities. The revenues in such cases would therefore be recognised on a proportionate basis by applying the PCM and the whole sale consideration would not be brought to tax as contended by the TO.

The takeaways

- The Tribunal decision has laid down that with respect to advances received pertaining to the unregistered sale deeds, tax would be levied on the amount realised post application of PCM on the amount of such advances realised.
- Further, in the case of real estate developers, where a sale deed for transfer of a plot is registered, the whole agreed sale consideration cannot be brought to tax in the year in

which such registration takes place.

- The specified activities which were closely linked to the sale of plot of land (which were construction of roads, provision of electricity etc. in this case) were yet to be performed by the taxpayer. The taxpayer will be obliged to perform the specified development activities even after the sale deeds were registered in favour of buyers.
- The application of the PCM is therefore necessary for determination of revenue that can be brought to tax for real estate developers.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

Our Offices

Ahmedabad

1701, 17th Floor, Shapath V,
Opp. Karnavati Club,
S G Highway,
Ahmedabad – 380051
Gujarat
+91-79 3091 7000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th
Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Telangana
+91-40 44246000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City,
Gurgaon – 122002
Haryana
+91-124 330 6000

Bengaluru

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bengaluru – 560 008
Karnataka
+91-80 4079 7000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata - 700 091
West Bengal
+91-033 2357 9101/
4400 1111

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006
Maharashtra
+91-20 4100 4444

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai – 600 006
Tamil Nadu
+91 44 4228 5000

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road (Station Road),
Bandra (West), Mumbai – 400 050
Maharashtra
+91-22 6689 1000

For more information

Contact us at
pwctr.knowledgemanagement@in.pwc.com

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